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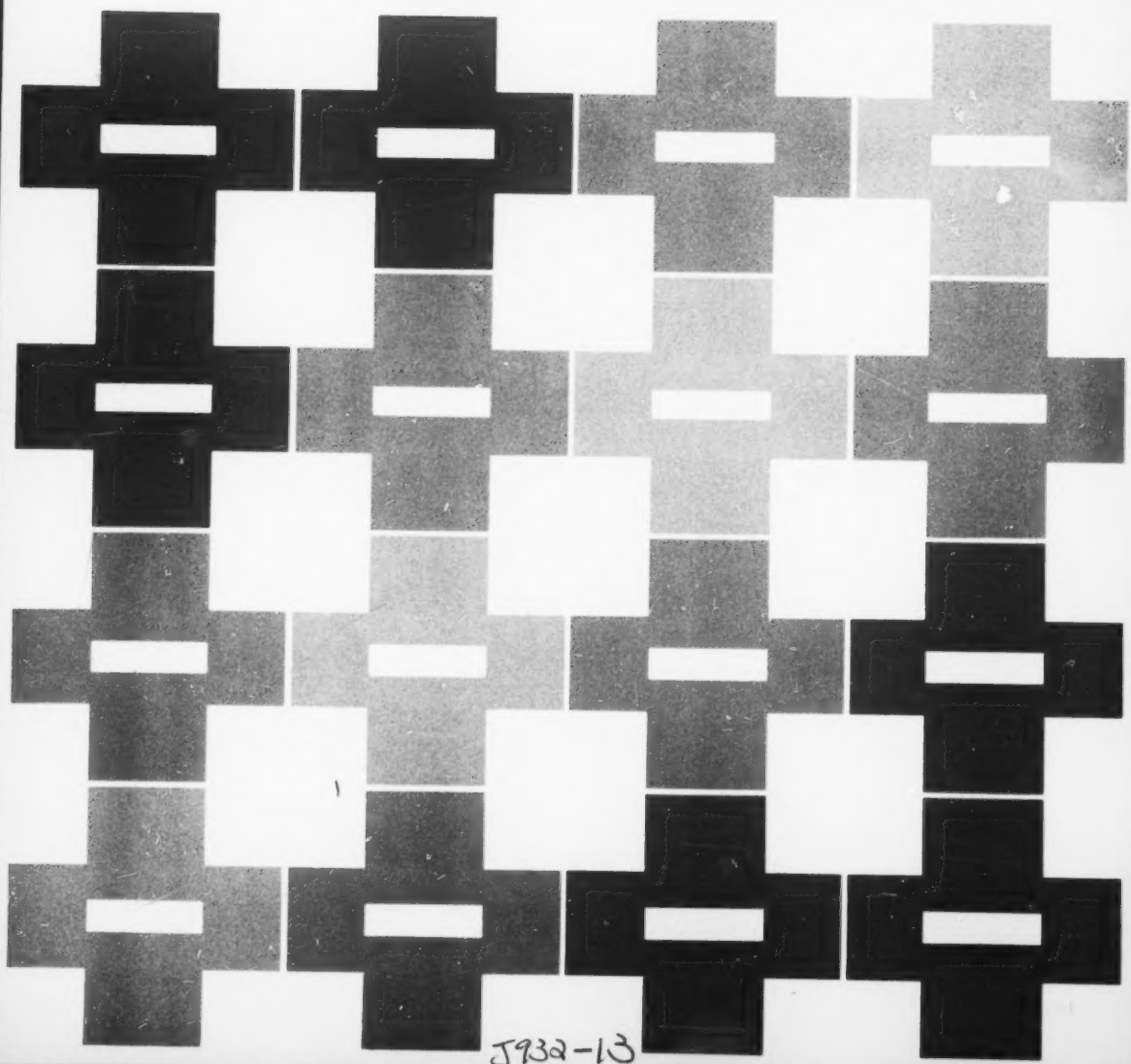
The Effects of Tax Reform on Tax Expenditures



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A CBO STUDY

THE EFFECTS OF TAX REFORM ON TAX EXPENDITURES

The Congress of the United States
Congressional Budget Office

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PREFACE

The Tax Reform Act of 1986 substantially reduced tax expenditures. The act affected tax expenditures directly by eliminating some and scaling back others, and indirectly by lowering tax rates and raising personal exemptions and the standard deduction. This report examines these effects. It fulfills a statutory requirement in section 308 (c) of the Congressional Budget and Impoundment Control Act of 1974 that the Congressional Budget Office report on tax expenditures.

The report was prepared by Pearl Richardson of the Tax Analysis Division, under the supervision of Rosemary D. Marcuss and Eric Toder. Richard Kasten, Mark B. Booth, and Larry Ozanne of the Tax Analysis Division commented on the manuscript and provided the revenue estimates that form the basis of the analysis in Chapter III. Several other people provided valuable comments, including Edward M. Gramlich, Robert W. Hartman, Rosemarie Nielsen, and Paul N. Van de Water. Amanda Balestrieri edited the manuscript. Linda Brockman and Shirley Hornbuckle prepared early drafts of the manuscript, and Nancy H. Brooks and Kathryn Quattrone prepared the final draft for publication.

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SUMMARY

The Tax Reform Act of 1986 (TRA) lowered tax rates for individuals and corporations and broadened the tax base. It differed from other tax legislation enacted in the 1980s in two major ways: it was more far-reaching, and it was revenue neutral. The act removed many tax preferences entirely, scaled back several others, set up a distinction between active and passive income, and prohibited losses from so-called "passive" business activities from being used to offset other income. Although many tax preferences remain, the overall effect of the legislation was to reduce their cost substantially.

Preferential treatment under the income tax code entails costs in the form of lost revenues, otherwise known as tax expenditures. As defined by the Budget and Impoundment Control Act of 1974, tax expenditures are federal revenue losses arising from provisions in the tax code that give selective relief to particular groups of taxpayers or special incentives for particular types of economic activity. Tax preferences deliver through the tax system government assistance that could otherwise be provided with loans or grants. Thus, they are comparable to direct spending programs; however, they are less visible and subject to less control in the budget process.

Tax expenditures are measured by comparing existing law with a "normal" income tax that does not include special provisions. TRA changed the normal tax structure by lowering marginal tax rates, increasing the personal exemption and the standard deduction, reducing the number of marginal tax brackets from fifteen to two, lowering the top corporate rate, imposing a new alternative minimum tax on corporations, and limiting the use of losses from passive business activity to offset other income.

The concept of passive business activity is new. Passive income results from trade or business activities in which a taxpayer does not "materially" participate, or from any rental real estate activity, regardless of whether the taxpayer materially participates. Under current law, losses from passive activities can be deducted only from gains from similar activities. Including the passive loss rules in the

normal tax structure makes exceptions to them tax expenditures for the first time. Thus, some deductions for the costs of doing business that once were part of the normal tax structure now are tax preferences with attendant costs.

TRA not only changed the normal tax structure, but also modified provisions directly governing tax expenditures. The act repealed a few of the most expensive tax preference items in prior law, including the investment tax credit and the capital gains deduction. It also repealed the deduction for state and local sales taxes and the deduction for two-earner married couples, set limits on tax-deductible contributions to individual retirement plans, phased out the deductibility of nonmortgage consumer interest, and modified the rules for depreciating equipment. (A summary of the effects of tax reform on some of the tax expenditures that were the most costly under prior law appears in Summary Table 1.)

Directly scaling back tax preferences and thereby broadening the tax base made it possible to reduce tax rates without increasing the deficit. Lower tax rates reduced the costs of remaining tax preferences. Thus, even though many tax expenditure items remain unchanged under current law, revenue losses from them have declined because lower tax rates and higher standard deductions and personal exemptions reduce the value of itemized deductions to taxpayers. Base broadening produces federal revenue gains, while lower rates lead to revenue losses; generally speaking, however, both types of measures reduce tax expenditures.

SUMMARY TABLE 1. PROJECTED REVENUE LOSSES FROM THE LARGEST TAX EXPENDITURES UNDER PRIOR LAW (In billions of dollars)

Tax Expenditure	Status After TRA	Projected Revenue Losses for Fiscal Year 1991	
		Before TRA	After TRA
Net Exclusion from Income of Pension Contributions & Earnings	Modified	71.7 a/	53.6 a/
Capital Gains Deduction	Repealed	56.1	0.0
Investment Tax Credit	Repealed	38.6	1.6 b/
Deductibility of Mortgage Interest on Owner-Occupied Homes	Modified	43.6	35.8 a/
Deductibility of State & Local Income and Sales Taxes	Sales Tax Repealed	36.1	18.4
Exclusion of Employer Contributions for Medical Insurance and Health Care	Unchanged	42.0	37.7
Exclusion of Social Security Benefits	Unchanged	23.8	20.3
Accelerated Depreciation: Equipment	Modified	23.9	16.5
Exemption of Income on Private Purpose Tax-Exempt Bonds	Modified	19.6	10.2
Exclusion of IRA Contributions and Interest Earnings	Modified	19.2	9.0
Deductibility of Charitable Contributions	Unchanged	19.9	13.9
Exclusion of Interest on General Purpose State and Local Bonds	Unchanged	17.4	10.9
Accelerated Depreciation: Nonresidential Structures	Modified	12.9	6.9

(Continued)

SUMMARY TABLE 1. (Continued)

Tax Expenditure	Status After TRA	Projected Revenue Losses for Fiscal Year 1991 Before TRA	After TRA
Nonmortgage Consumer Interest Deductions	Phased Out	14.7	0.9 c/
Deductibility of Real Estate Taxes	Unchanged	12.4	8.9
Progressive Corporate Tax Rates	Modified	10.2	5.5
Deduction for Two-Earner Married Couples	Repealed	9.4	0.0
Exclusion of Untaxed Medicare Benefits	Unchanged	9.1	8.0
Deferral of Capital Gains on Home Sales	Unchanged	13.0	11.6
Exclusion of Capital Gains at Death	Unchanged	6.5	5.1
Exclusion of Capital Gains on Home Sales for People 55 or over	Unchanged	4.3	3.9

SOURCES: Congressional Budget Office and Joint Committee on Taxation estimates.

NOTES: TRA = Tax Reform Act of 1986.

The year 1991 was chosen for comparison of projected tax expenditures because virtually all of the provisions of TRA will then be fully in effect.

The estimates under both prior law (before TRA) and current law (after TRA) are based on the same economic assumptions. These are from CBO's January 1988 forecast, which included projected changes in investment activity brought about by TRA.

a. Estimates take into account the effects of the Omnibus Budget Reconciliation Act of 1987. Relative to TRA, the Reconciliation Act reduced tax expenditures by small amounts.

b. Revenue losses after TRA result from unused credits carried forward from previous years.

c. Revenue losses in fiscal year 1991 result from deductions taken during calendar year 1990.

CHAPTER I

INTRODUCTION

The Tax Reform Act of 1986 (TRA) brought about sweeping changes in tax law that, among other effects, substantially reduced tax expenditures. The Congressional Budget and Impoundment Control Act of 1974 (Public Law 93-344), more commonly referred to as the Budget Act, requires the President and the Congressional Budget Office (CBO) to prepare lists of tax expenditures with estimates of their costs each year. The Budget Act defines tax expenditures as federal revenue losses arising from provisions in the income tax code that give selective relief to particular groups of taxpayers or special incentives for particular types of economic activity. The use of the term assumes that the tax code has both normal and preferential elements. In addition, it suggests that the preferential elements are comparable to spending programs; that is, they deliver through the tax system government assistance that could be provided with loans, grants, or other direct funding.

Tax legislation can affect tax expenditures in several ways: by repealing or limiting some special preferences; by enacting others; and, perhaps more importantly, by changing the normal code, thus redefining tax expenditures and altering their estimated costs, which often depend on tax rates. This study examines these aspects of the recent tax reform and shows that TRA had all of these effects. The Omnibus Budget Reconciliation Act (Public Law 100-203), passed in December 1987, also lowered some tax expenditures, but, with few exceptions, its effects were comparatively modest. The report notes the exceptions.

DEFINING TAX EXPENDITURES

Each year, the Joint Committee on Taxation (JCT) publishes five-year projections of tax expenditures for the use of the tax committees (the House Committee on Ways and Means and the Senate Committee on

Finance). The JCT also submits its tax expenditure estimates to the House and Senate Committees on the Budget. The JCT and CBO lists are identical. In defining tax expenditures, CBO and JCT distinguish between the "normal" (basic) and exceptional features of an income tax. The exceptions may take the form of special exclusions, exemptions, or deductions; preferential rates; special credits that are subtracted from tax liability; or deferrals of tax liability. Tax expenditures do not include exceptions to or deductions from excise, employment, or estate and gift taxes.

For individuals, the normal income tax structure includes general rate schedules and exemption levels, the standard deduction, and general rules defining the taxpaying unit and setting forth accounting periods. The many exceptions to the normal structure include deductions for charitable contributions and state and local income taxes, and the exemption from federal taxation of interest earned on state and local government debt.

A separate corporate tax is considered part of the normal structure. For corporations, the normal structure includes deductions for ordinary and necessary expenses, but it does not include graduated rates on the grounds that these are intended to provide relief to small businesses. Corporate rates below the maximum, corporate tax credits for particular types of investment (such as research and development), and accelerated depreciation of machinery and equipment are only a few of the items that appear on the tax expenditure lists published by JCT and CBO (see Appendix A).

At times, distinguishing between the provisions of the normal tax structure and tax expenditures is difficult. The Budget Act does not specify what shall be included in the normal tax structure. Depending on how the normal tax structure is defined, certain provisions may or may not be considered tax expenditures.

For many years, the tax expenditure lists of the Administration and Congressional agencies were virtually identical. In 1982, however, the Administration introduced the concept of a "reference" tax structure as an alternative to the normal tax structure. It has since

reported tax expenditures relative to both concepts.1/ In determining tax expenditures relative to the reference structure, the Administration uses more restrictive criteria than JCT and CBO.

The treatment of accelerated depreciation illustrates one of the differences between the normal and the reference tax structures. The normal tax structure includes schedules of cost recovery deductions on equipment and structures intended to approximate the useful life of property. JCT and CBO consider depreciation that is more accelerated than the normal amount to be a departure from the basic rules; the Administration, however, considers whatever depreciation system is in the tax code to be part of the reference tax structure.2/

The reference rules tend to adhere more closely to current law than CBO's and JCT's concept of the normal tax structure. A provision results in a tax expenditure under the reference rules if it is "special" in two senses: it is a clear exception to a general provision in the tax law, and it applies to a narrow class of taxpayers or transactions. Since current tax law applies general rules to a full range of depreciable assets to determine variable depreciation rates, any acceleration of depreciation relative to the useful life of an asset would not fit the Administration's definition of a tax expenditure under the reference rules. Similarly, corporate tax rates that are below the maximum are part of the reference tax rules, even though they are exceptions to the normal tax structure and fall within CBO's and JCT's definition of tax expenditures.

Although the Administration has thus far reported tax expenditures relative not only to the reference, but also to the normal tax structure, its list contains fewer items than the list prepared by JCT. The differences between the lists result largely from JCT's having

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1. Executive Office of the President, Office of Management and Budget, *Special Analyses, Budget of the United States Government, Fiscal Year 1988*, pp. G-37 to G-46, and *Fiscal Year 1989*, pp. G-41 to G-45.

2. Both JCT and CBO base their calculations of tax expenditures for depreciation of equipment on the difference between the current law depreciation schedule and straight-line depreciation over the period defined by the midpoint of the Asset Depreciation Range (ADR) system that was in effect from 1971 to 1981. The tax expenditure for structures is based on the difference between current law depreciation and straight-line depreciation over 40 years.

added provisions recommended for repeal in the tax reform proposals put forth by the Treasury Department and the President in 1984 and 1985. Also, the lists cover different years: JCT's list covers five years; the Administration's, three. Finally, JCT's list includes repealed and expired provisions that still result in revenue losses because of transition rules. (A list of the differences between the lists of the Congressional agencies and the Administration appears in Appendix B.)3/

MEASURING TAX EXPENDITURES

If tax expenditures are sometimes difficult to define, they are no less difficult to measure. Estimates of tax expenditures reflect the amount of revenue that the federal government forgoes as the result of the special provisions in the tax code. They are estimates of revenue losses, funds that the federal government does not collect. These estimates are imprecise: the revenues that the federal government collects and spends are open to direct observation and fairly precise measurement, whereas uncollected funds are not. Measuring some tax expenditures once they have occurred, however, may be fairly straightforward. For example, the cost of tax credits is based on the amounts claimed on tax returns and is therefore as knowable after the fact as many direct expenditures.

JCT and CBO estimate the revenue loss from each tax expenditure by comparing the revenue raised under current law with the revenue that would be raised if the provision did not exist, assuming that taxpayer behavior and all other tax provisions remain unchanged. Revenue loss estimates on tax expenditure lists measure only the isolated effects of each provision. The interaction of different tax expenditures and other tax provisions could make the combined revenue gain from repealing two or more tax expenditure provisions simultaneously either more or less than it would be from repealing them separately.

Any attempt to add separately reported tax expenditures can have misleading results for the same reason. Interactions among tax ex-

3. See also Congressional Budget Office, *Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1984-1988* (October 1983).

penditures--and between tax expenditures and the normal tax structure--are such that the total might be greater or less than the sum of the parts. For example, if several tax expenditures taking the form of personal deductions did not exist, more people would take the standard deduction, so that revenue would be higher by less than the sum of the individual estimates. Conversely, if several income tax exclusions no longer existed, more income would be taxed at higher marginal rates, so that revenue would be higher by more than the sum of the individual estimates. In short, tax expenditure line items are generally not additive.

A revenue loss estimate may or may not be a measure of the revenue gain that would result from repeal of a tax expenditure. Repeal of a tax expenditure could change taxpayer behavior in ways that might make the gain different from the estimated loss. In addition, some tax expenditures result in continuing long-term losses that repeal of the tax provision may reduce but will not eliminate--in part because changes in tax law often are not retroactive and may even phase in transitional provisions for new transactions. When state and local governments issue tax-exempt bonds, for example, the federal government sustains revenue losses for as long as the issues are outstanding. So far, including interest on certain state and local bonds in taxable income has affected new issues only, so that revenue losses will persist for many years.

While JCT and CBO use revenue loss as the standard for measuring tax expenditures, the Administration also calculates them in terms of their outlay equivalents--the amount necessary to provide an equivalent level of resources through a direct expenditure program. Outlay equivalents are an analytic tool used to compare direct budget expenditures and tax expenditures. Estimates of outlay equivalents will sometimes differ from revenue loss estimates. In general, if an outlay program corresponding to a tax expenditure would generate additional taxable income, then revenue loss estimates are increased ("grossed up") to reflect those estimated higher tax payments. Tax expenditures that would not result in a change in taxable income under the comparable outlay program are not increased. If no grossing up is involved, revenue loss and outlay equivalent estimates may nevertheless differ slightly for reasons connected with the timing of outlays and collections.

CONTROLLING TAX EXPENDITURES

Although the Treasury Department formally developed the concept of tax expenditures in the late 1960s, the first Congressional attempt to control them came with the Budget Act of 1974, which required periodic reports and continuing efforts to coordinate them with direct budget outlays. The budget process, which involves the adoption of a binding concurrent resolution with revenue and expenditure totals, exerts some restraint on tax expenditures. In general, however, tax expenditures are subject to less control in the budget process than are many spending programs. Spending programs subject to annual appropriations or periodic reauthorizations are regularly reviewed. Tax expenditures generally are not, although those that are scheduled to expire might undergo review if their renewal is being considered.

Measures that would increase or decrease tax expenditures come under the jurisdiction of the House Committee on Ways and Means and the Senate Committee on Finance, while most spending programs that might be considered as alternatives come under the jurisdiction of other committees.4/ This organization makes trade-offs between tax expenditures and direct spending difficult to consider, even though they may be alternative means of accomplishing the same objective. Thus, tax credits for rehabilitating low-income housing may substitute for federal grants, and financing projects with tax-exempt bonds may substitute for direct loan subsidies, but trade-offs between such alternative forms of assistance are unlikely.

The budget resolution does not set targets for tax expenditures by budget functional categories, as it does for spending programs. Nevertheless, it imposes some constraints on tax expenditures by setting an overall revenue floor, thus requiring that any new tax expenditures that would reduce revenues below the floor be compensated for by decreases in other tax expenditures or increases in the normal tax. Before adoption of the resolution, no bill can be considered that would change revenues in the forthcoming budget year. More important, once the budget resolution is passed, setting an overall revenue floor,

4. Some major entitlement programs, such as Social Security and Medicare, are also under the jurisdiction the House Committee on Ways and Means and the Senate Committee on Finance.

any legislation that would reduce total revenues below the floor is subject to a point of order. Therefore, any increases in tax expenditures have to compete with all other revenue-losing provisions for whatever tax reduction may be possible under the resolution. Moreover, each bill increasing or reducing taxes is accompanied by a report giving an estimate of the revenue effects for the next five years. This situation is not very different from the discipline that applies to spending programs.

Changes in tax expenditures have the same effect on the federal deficit as do any other tax or spending changes, and thus receive the same attention and scrutiny. At times, the Congress has required studies of the effectiveness of particular tax expenditures. Generally, the purpose of these studies is to provide information that will help the Congress decide whether to extend a particular provision or to let it expire. More significantly, however, the Congress has enacted several major tax laws in recent years, culminating in the Tax Reform Act of 1986, and in each instance, tax expenditures came under review and were affected in important ways.

TAX LEGISLATION AND TAX EXPENDITURES, 1981-1984

The Tax Reform Act of 1986 (TRA)--Public Law 99-514--was the fourth major tax measure enacted in the 1980s. Unlike the others, it was designed to be revenue neutral in the long run. It eliminated or scaled back many tax preferences, thus making available the revenues necessary to reduce tax rates without increasing the deficit. The two immediately preceding major revisions of the income tax, enacted in 1982 and 1984, had sought to reduce tax expenditures and to increase revenues.

The Economic Recovery Tax Act of 1981 (ERTA)--Public Law 97-34--lowered marginal tax rates and expanded tax preferences for both individuals and corporations. With ERTA, the Congress enacted many new tax expenditures, including deductions for two-earner married couples and for expenses incurred in adopting a child. ERTA also increased child care credits, permitted nonitemizers to take a deduction for charitable contributions, and raised the limits and expanded eligibility for tax-exempt contributions to individual retire-

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ment accounts. Among its many provisions affecting businesses, ERTA shortened capital cost recovery periods for most assets, further accelerated depreciation, expanded the classes of machinery and equipment eligible for the investment tax credit, enacted a new credit for research expenditures, expanded the tax credits for rehabilitation of older buildings, and enacted safe-harbor leasing provisions that made it possible for one corporate entity to transfer tax benefits to another. In total, only two provisions of ERTA directly reduced tax expenditures, while more than 30 increased them.

Concern about the growing federal budget deficit led to passage of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)--Public Law 97-248--which directly reduced a dozen tax expenditures. Among several other measures, TEFRA raised the floor for medical deductions, limited the deduction for nonbusiness casualty and theft losses, lowered the income levels for the exclusion of unemployment compensation benefits, repealed the scheduled future acceleration of depreciation, scaled back by 15 percent a number of corporate tax preferences, repealed safe-harbor leasing, required a basis adjustment for the investment tax credit, and set new limits on the use of tax-exempt bonds for private purposes.5/

Two years later, the Congress, again in response to concern about a growing deficit and an eroding tax base, passed the Deficit Reduction Act of 1984 (DEFRA), Public Law 98-369.6/ DEFRA postponed 10 tax reductions scheduled to take effect in 1984 and subsequent years, increased the reductions in corporate tax preferences enacted under TEFRA from 15 percent to 20 percent, and required corporations to capitalize, rather than expense, construction period interest and taxes on residential property (other than low-income housing). Reflecting a Congressional desire to curb the growth of real estate tax shelters that had followed the enactment of ERTA, DEFRA increased the recovery

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5. For information on the effects of ERTA and TEFRA on tax expenditures, see Congressional Budget Office, *Tax Expenditures: Budget Control Options and Five-Year Projections for Fiscal Years 1983-1987* (November 1982). See also Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981* (December 31, 1981), and *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* (December 31, 1982).

6. For details of provisions, see Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (December 31, 1984). DEFRA is composed of two parts: the Tax Reform Act of 1984, which contains most of the revenue provisions, and the Spending Reduction Act of 1984, which has some tax-related provisions but deals primarily with other issues.

period for depreciable real estate (other than low-income housing) from 15 to 18 years. This change, coupled with provisions limiting tax benefits from the sale and leaseback of real property, represented further efforts to reduce tax-motivated investment. Additionally, continued concern about the relatively uncontrolled growth of federal tax expenditures for private-sector activities resulted in further limits on the use of tax-exempt bonds for nongovernmental facilities. Many of the provisions of TRA, passed two years later in 1986, stemmed from similar concerns. TEFRA and DEFRA began the tax reform process by chipping away at preferences enacted in 1981 and earlier; TRA went much further.

CHAPTER II

TAX REFORM AND THE NORMAL TAX STRUCTURE

With the Tax Reform Act of 1986, the normal tax structure changed. For corporations, the new features included lower marginal tax rates and a new alternative minimum tax. The new features of the individual income tax included not only lower marginal tax rates, but also a higher standard deduction in place of the former zero bracket amount, higher personal exemptions, fewer marginal tax brackets, and limits on the use of "passive" business activity losses to offset other income. All of these changes affected tax expenditures. The last change, however, is noteworthy, for reasons that go beyond its effect on tax expenditure costs. By definition, the normal tax system has always included whatever the rate structure, personal exemption, and standard deduction (or its equivalent) happen to be at any one time. In contrast, the concept of passive income is new. Moreover, it highlights some of the issues that arise in defining tax expenditures.

CHANGES IN THE RATE STRUCTURE

Even if the new law had left all tax preferences intact, most tax expenditures would have declined. In cases where tax expenditure items were unchanged from prior law, revenue losses will be lower because lower tax rates, higher standard deductions and personal exemptions for individuals, and a broader minimum tax for both individuals and corporations reduce the value of most tax preferences. In brief, broadening the tax base made it possible to lower tax rates without increasing the deficit, while lower tax rates reduced the costs of remaining tax preferences.

Individual Taxes

For individuals, tax rates beginning in 1988 are 15 percent and 28 percent, replacing the schedule of rates that under prior law had extended up to 50 percent. Some taxpayers now face a marginal tax rate of 33 percent--a result of the top statutory rate of 28 percent plus a 5 percent surcharge associated with the phase-out of both personal exemptions and the value of the 15 percent bracket in certain income ranges. (For 1988, these ranges are between $43,150 and $100,480 of taxable income for single taxpayers and between $71,900 and $171,090 for married taxpayers filing jointly with no dependents.) For taxpayers with incomes above these levels, the phase-out is complete, so they do not pay the surcharge.

Under TRA, the zero bracket amount (equivalent to a standard deduction), was replaced by a higher standard deduction. In 1988, the standard deductions are $5,000 for married individuals filing jointly; $4,400 for heads of households; $3,000 for single individuals; and $2,500 for married individuals filing separately. The act also increases the personal exemption for each individual to $1,950 in 1988 and $2,000 beginning in 1989. For the elderly and the blind, the act provides additional standard deduction amounts of $600 for married individuals and $750 for single individuals. These substitute for the extra personal exemptions in prior law.

Beginning in 1989, the new rate brackets will be adjusted for inflation to reflect changes in the average Consumer Price Index between the 12-month period ending on August 31, 1987, and the most recent 12-month period. The inflation adjustment will apply to the income breakpoint between the 15-percent and 28-percent brackets, and to the threshold for the phase-out of the personal exemption and the value of the 15-percent bracket. The standard deduction also will be adjusted for inflation beginning in 1989; the personal exemption will be adjusted beginning in 1990.

Revenues from individual income taxes in fiscal year 1991--when nearly all of the provisions of TRA will be fully phased in--will be about $22 billion less than under prior law.

Corporate Taxes

The new law will result in increased corporate income taxes because base-broadening provisions more than compensate for lower rates. In fiscal year 1991, corporate tax payments will be about $27 billion greater than under prior law.

Under prior law, corporate income was subject to a five-step graduated tax rate structure. The top corporate rate was 46 percent on income above $100,000. The new act lowered the top corporate rate to 34 percent on income above $75,000. The bottom corporate rate is 15 percent on income below $50,000. An additional 5 percent surtax is imposed on a corporation's taxable income in excess of $100,000. The maximum additional tax is $11,750. This provision phases out the benefit of graduated rates for corporations with taxable income between $100,000 and $335,000. Corporations with income in excess of $335,000 will pay a flat tax at a 34 percent rate.

MINIMUM TAX PROVISIONS

TRA expanded the alternative minimum tax for individuals and replaced the add-on minimum tax for corporations with a new and tougher alternative minimum tax. The purpose was to ensure that no individual or corporation with substantial economic income would be able to avoid tax liability by using the exclusions, deductions, and credits that were retained in the tax law.

Under prior law, individuals were subject to an alternative minimum tax that was payable, in addition to other tax liabilities, to the extent that it exceeded the regular tax owed. The tax was imposed at a flat rate of 20 percent on alternative minimum taxable income. This was generally equal to adjusted gross income (AGI), plus specified tax preferences and less certain itemized deductions. An exemption of $40,000 for joint returns, $30,000 for single returns, and $20,000 for married individuals filing separately was subtracted from alternative minimum taxable income before applying the 20 percent rate. The tax preferences that were added to AGI for minimum tax purposes included such items as the excess of accelerated over straight-line depreciation during specified recovery periods for real

estate and leased personal property, and any dividends or net capital gains excluded from gross income. Some of the itemized deductions that were allowed in calculating the alternative tax included casualty or theft losses, charitable contributions, medical costs exceeding 10 percent of gross income, certain interest expenses, and estate taxes. Deductions for other taxes permitted under the regular tax were disallowed under the minimum tax. These included deductions for state and local taxes on income, real estate, and personal property. The standard deduction was also disallowed.

TRA raised the minimum tax rate for individuals to 21 percent, added to the list of tax preference items, disallowed some itemized deductions, and reduced (but not below zero) the exemption amounts. The exemption was reduced by 25 percent of the amount by which alternative minimum taxable income exceeds $150,000 for married taxpayers filing jointly, $112,500 for single taxpayers, and $75,000 for married taxpayers filing separately. The minimum tax is based on regular taxable income plus tax preference items and any itemized deductions permitted under the regular tax but disallowed under the minimum tax.

For corporations, the changes in the minimum tax were more far-reaching. Under prior law, corporations paid a 15 percent add-on minimum tax on a fairly narrow range of tax preferences that included the excess of accelerated over straight-line depreciation of real property and a percentage of net capital gains (that is, the equivalent of eighteen-forty-sixths, intended to reflect the difference between the 28 percent rate on corporate capital gains and the 46 percent rate on corporate income). The new law imposes on corporations a broad-based alternative minimum tax at a 20 percent rate, with a $40,000 exemption amount that is phased out once income exceeds $150,000. A firm pays the minimum tax or the regular tax, whichever is greater. The number of tax preference items included in the minimum tax base is much larger than under prior law. In addition to specified preferences, the base for the minimum tax includes one-half of the difference between net book income not otherwise subject to tax in 1988 and 1989 and alternative minimum taxable income (before addition of this preference). From 1990 on, the base will be adjusted current earnings, instead of book income. The purpose of all of these provisions is to ensure that firms pay taxes equal to at least 20 percent of an amount approximating their economic income.

Some of the tax preferences and adjustments that apply to both individuals and corporations for purposes of the alternative minimum tax include: the difference between accelerated and straight-line depreciation calculated over longer recovery periods than under the regular tax; the difference between expensing and 10-year straight-line amortization of mining exploration and development costs; tax-exempt interest earned on bonds for private activities; the adjusted basis of appreciated property contributed to charity; intangible oil and gas income that exceeds 65 percent of net oil and gas income; use of the percentage of completion instead of the completed contract method of accounting; and the difference between rapid amortization of pollution control facilities and the usual amortization allowed under the regular tax rules.

Such provisions reduce the value of tax preferences for many taxpayers. Most of the tax preference items that are included in calculating liabilities under the minimum tax also result in tax expenditures. If a tax expenditure--for example, rapid amortization of pollution control facilities--is also a preference under the minimum tax rules, then its estimated cost will be reduced by its associated minimum tax liabilities. The tax expenditure estimates in this report represent net revenue losses; that is, for any preference, they take into account whatever revenues are collected under the minimum tax rules for that preference. Thus, in broadening the base of the minimum tax and raising its rates, TRA reduced the costs of many tax expenditures.

PASSIVE INCOME PROVISIONS

The provisions relating to passive income both reduced some tax expenditures and created new ones. They also illustrate some of the ambiguities that arise in defining tax expenditures. In recent years, tax legislation has included an increasing number of distinctions among different sources of income. Without these distinctions, all income would be taxed similarly, regardless of the activity that generated it, and losses from any activity would be deductible from total income, regardless of their source. Under TRA, apart from specified exceptions, losses from passive activities can be deducted only from gains from similar activities; capital losses can be deducted only from

capital gains; and interest deductions on property purchased for investment are limited to net investment income.

Passive income results from trade or business activities in which the taxpayer does not "materially" participate. An individual taxpayer materially participates in a business by being involved in its operations on a "regular, continuous, and substantial basis."1/ In general, facts and circumstances will determine whether a taxpayer's activities meet the criteria for material participation; however, in order to make it unnecessary to examine facts and circumstances in a large number of cases, the act treats interests in limited partnerships as intrinsically passive. Most tax shelter investments take the form of limited partnership interests, and, to retain their limited liability status, limited partners are generally precluded from participating in the operations of a business. Portfolio income (such as from stocks and bonds) of a partnership, however, is not treated as passive, nor are working interests in oil and gas properties, whether or not the taxpayer materially participates.

All rental activity is passive, again regardless of whether the taxpayer materially participates. Rental activities include long-term leases of property and equipment (such as apartments, office space, computers, or cars). Income from operating a hotel or motel, however, is not passive, nor are fees from managing leased property, because payment for these activities is primarily for providing services and not for the rental activity alone.

Losses from passive activities may be applied only against income from such activities and not against any other income, such as portfolio income or earned income. Interest expense allocable to passive activities is treated as a passive activity expense and not as investment interest. Thus, deductions otherwise allowable for interest expense are subject to limits under the passive loss rule.

If passive losses exceed passive income in any year, the losses may be carried forward. When a taxpayer disposes of his interest in a passive activity, the unused losses carried forward are allowed in full; however, to the extent that the loss is from the sale of a capital asset, it

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1. Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (May 4, 1987), p. 218.

is limited to the amount of gains on capital assets (plus $3,000 in the case of individuals).

Distinguishing between active and passive income can be difficult. For example, as stated above, any activity that involves the holding of rental property is by definition passive, regardless of the taxpayer's level of participation, but providing management services for rental properties is not a passive activity. Thus, a developer who provides management services for a related partnership that holds rental property may not be able to avoid a situation in which he receives active income that cannot be offset by passive losses from the same property.

For rental real estate, TRA further distinguishes between active and nonactive participation in order to provide relief from the passive loss rules for owners with moderate incomes. The act sets a lesser standard for active than for material participation: the requirements for active participation are an ownership interest of 10 percent or more, but not as a limited partner, and some involvement in management decisions. Individuals with incomes below certain levels may offset up to $25,000 of ordinary income with passive losses from rental real estate. This offset is reduced (but not below zero) by 50 percent of the amount by which the taxpayer's adjusted gross income exceeds $100,000 ($200,000 if passive losses stem from low-income housing and rehabilitation credits). The passive loss rules apply fully to all interests acquired after October 22, 1986. For property acquired before the passage of TRA, the rules will be phased in over four years, becoming fully effective in 1991.

The rules regarding passive income will bring about a shift away from tax-motivated investment and, with changes in depreciation rules and capital gains taxation, will reduce revenue losses from tax shelters, particularly in real estate. Prior law heavily favored real estate investment. The passive loss rules will partially recapture some of the revenue losses that otherwise would have resulted from investments made in real estate tax shelters before TRA was enacted.

Including the passive loss rule in the normal tax structure makes any exception to it a tax expenditure item for the first time. Current law has four such exceptions: for working interests in oil and gas

properties, for rehabilitation of structures, for low-income housing, and for $25,000 of rental losses in properties owned by taxpayers with incomes below specified limits. These exceptions indicate the ambiguities that may arise in defining tax expenditures. TRA reduced tax expenditures generally. The passive loss provisions specifically reduced them by creating disincentives to invest in tax shelters. Because any exceptions to the passive loss rules are tax expenditures, however, some deductions for the costs of doing business that once were part of the normal tax structure are now treated as tax preferences.

The passive loss provisions illustrate that defining tax expenditures may be difficult and, at times, may depend less on the weight of argument than on consensual decisions. For example, tax expenditures currently exclude exceptions to payroll and excise taxes, but the concept could as easily encompass all tax preferences. A separate corporate tax is currently considered part of the normal income tax structure, but it need not be. Similarly, as currently defined, the normal structure includes distinctions among different sources of income, setting limits, for example, on the amount of capital losses or passive activity losses that may be deducted from salaries and wages. These distinctions and limits, however, could as easily be regarded as artificial. In brief, despite their usefulness as a budget concept, defining tax expenditures involves making decisions that may not be straightforward and may sometimes be arbitrary.

CHAPTER III

TAX REFORM AND TAX EXPENDITURES

The Tax Reform Act of 1986 reduced tax expenditures directly by removing many tax preferences entirely and reducing others, and indirectly by lowering marginal tax rates and raising the standard deduction and personal exemption. Thus, in cases where tax preferences were scaled back, the resulting reduction in tax expenditures stems both from the new limits and from lower tax rates.

BASE-BROADENING MEASURES

Cutting back or completely eliminating many tax preferences results in reduced tax expenditures, which largely compensate for the revenue losses resulting from lower marginal rates and, for individuals, higher standard deductions and personal exemptions. Base broadening shifted some of the tax burden from individuals to corporations.

The main reductions in tax expenditures resulted from repeal of the investment tax credit, repeal of special treatment for income from capital gains, repeal of deductions for nonmortgage interest, limits on deductible IRA contributions and other elective deferrals, and repeal of the deduction for two-earner couples. A comparison of the hypothetical costs of these incentives under prior law with their estimated costs under current law can be found in Table 1. The comparisons in the table and in the following paragraphs are for fiscal year 1991, when nearly all of the provisions of the act will be fully phased in, and are based on CBO's January 1988 economic assumptions.

TABLE 1. PROJECTED REVENUE LOSSES FROM SELECTED TAX EXPENDITURES CHANGED BY TRA (In billions of dollars)

Tax Expenditure	Status After TRA	Projected Revenue Losses for Fiscal Year 1991	
		Before TRA	After TRA
Investment Tax Credit	Repealed	38.6	1.6 a/
Capital Gains Deduction	Repealed	56.1	0.0
Accelerated Depreciation: Equipment	Modified	23.9	16.5
Accelerated Depreciation: Nonresidential Structures	Modified	12.9	6.9
Nonmortgage Consumer Interest Deductions	Phased Out	14.7	0.9 b/
Deductibility of Mortgage Interest on Owner-Occupied Homes	Modified	43.6	35.8 c/
Exclusion of IRA Contributions and Interest Earnings	Modified	19.2	9.0
Net Exclusion from Income of Pension Contributions and Earnings	Modified	71.7	53.6 c/
Deduction for Two-Earner Married Couples	Repealed	9.4	0.0
Exclusion of Interest on Private-Purpose Tax-Exempt Bonds	Modified	19.6	10.2

SOURCES: Congressional Budget Office and Joint Committee on Taxation estimates.

NOTES: TRA = Tax Reform Act of 1986.

The year 1991 was chosen for comparison of projected tax expenditures because virtually all of the provisions of TRA will then be fully in effect.

The estimates under both prior law (before TRA) and current law (after TRA) are based on the same economic assumptions. These are from CBO's January 1988 forecast, which included projected changes in investment activity brought about by TRA.

a. Revenue losses after TRA result from unused credits carried forward from previous years.

b. Revenue losses in fiscal year 1991 result from deductions taken during calendar year 1990.

c. Estimates take into account the effects of the Omnibus Budget Reconciliation Act of 1987. Relative to TRA, the Reconciliation Act reduced these tax expenditures by small amounts (less than $0.1 billion in the case of mortgage interest deductions and less than $0.6 billion in the case of the exclusion from income of pension contributions and earnings).

Investment Tax Credit

TRA repealed the regular investment tax credit (ITC) and reduced credits carried forward by 35 percent.1/ Under prior law, a credit against income tax liability was allowed for up to 10 percent of a taxpayer's investment in tangible depreciable property (machinery and equipment, but not structures). Without the enactment of tax reform, the estimated revenue loss from the ITC for fiscal year 1991 would have been nearly $41 billion. Under current law, the estimated loss is less than $2 billion from carryforwards of credits earned before 1986.

Depreciation

TRA also changed the depreciation rules, generally providing a more accelerated depreciation method for machinery and equipment, but also extending recovery periods for some assets. Under prior law, most machinery and equipment fell into the three-, five-, or ten-year classes. The act revised these classes, reclassified some assets, and created a seven- and a twenty-year class. The modifications placed most machinery formerly in three- and five-year classes in five- and seven-year classes. Although asset lives are longer, the depreciation method is now also more accelerated: the assets falling into the revised three-, five-, and ten-year classes can now be depreciated using the 200 percent declining balance method, compared with 150 percent under prior law.2/ The 150 percent declining balance method applies to assets in the 15- and 20-year classes. For structures, TRA provided less accelerated depreciation than prior law, extending the previous recovery period of 19 years at a 175 percent declining balance (switching to straight-line depreciation) to 27.5 years straight-line depreciation for rental housing and to 31.5 years straight-line depreciation for nonresidential real property.

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1. Transition rules allow ITC's for investment contracted for before 1986 as long as the property is placed in service by certain time limits, in no case later than January 1991.

2. Declining balance methods provide higher depreciation in the early years of an asset's life than in the later years. Annual depreciation using the 200 percent, or double declining balance method is equal to:

$$\frac{2}{\text{Depreciable Life}} \times \text{Current Book Value}$$

The current book value of an asset equals its original cost minus total depreciation to date.

Estimated fiscal year 1991 revenue losses from accelerated equipment depreciation are $16.5 billion, compared with nearly $24 billion estimated under prior law. The estimated revenue loss in 1991 for rental housing depreciation would have been more than $2 billion under old law, almost twice as much as under current law. For nonresidential real property, the estimated cost would have been about $13 billion under old law, compared with about $7 billion under current law. These estimates are for the differences between accelerated depreciation and an alternative method that more closely approximates economic depreciation.3/

Capital Gains

TRA removes the special deduction for long-term capital gains income, thereby subjecting capital gains to the rates prevailing for ordinary income. Under prior law, individuals and other noncorporate taxpayers could deduct from gross income 60 percent of the amount of any net long-term capital gain from the sale of capital assets. Because the remaining 40 percent was taxed at no more than a 50 percent rate, the maximum tax on capital gains was 20 percent. Under prior law, the estimated revenue loss in 1991 for the capital gains preference would have been about $56 billion.4/ The repeal of the deduction, however, is projected to raise revenue by much less than $56 billion because capital gains realizations will probably decline in response to higher rates. Moreover, even if the deduction were not repealed, the tax expenditure would be lower because of lower tax rates.

The act left unchanged the exclusion of capital gains at death, the deferral of capital gains on home sale rollovers, and the one-time exclusion of capital gains up to $125,000 on home sales for individuals age 55 or over. These tax expenditures will amount to approximately $21 billion in 1991, compared with $24 billion under prior law.

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3. For a description of the basis for CBO's calculations of tax expenditures for depreciation of equipment and structures, see Chapter I.

4. As under prior law, half of net long-term capital losses and 100 percent of net short-term capital losses may now be offset against ordinary income up to a maximum deduction of $3,000 a year with an unlimited carryforward. These are not tax expenditures.

Interest Deductions

Current law sets stringent limits on deductions for consumer and investment interest. TRA phases out over a five-year period the deduction for nonmortgage consumer interest. The deduction for interest on debt incurred to purchase property for investment was limited under prior law to $10,000 a year, plus the taxpayer's net investment income. Under current law, the deduction permitted in any year may not exceed investment income; however, if interest paid on investment indebtedness exceeds the limit, it may be carried over and deducted in future years (subject to applicable limits). Under prior law, the projected 1991 tax expenditure for nonmortgage interest deductions that exceeded investment income would have been nearly $15 billion. The projected expenditure under current law is less than $1 billion.

TRA also limited the amount of interest that individual taxpayers can deduct on owner-occupied homes. Under TRA, interest on debt secured by a principal or second residence was deductible to the extent the debt did not exceed the purchase price of the property and improvements, plus debt for medical and educational expenses. The Omnibus Budget Reconciliation Act of 1987, referred to as the Reconciliation Act, revised these limits. Current law continues the deductibility of interest on debt secured by the taxpayer's principal residence or on a second home. Interest on debt to acquire or improve a principal or second residence, or both, is now limited to $1 million; interest on other debt secured by a principal or second residence is limited to $100,000. This change had little effect on tax expenditures.

Estimated tax expenditures in 1991 for home mortgage interest deductions under current law are about $36 billion, down from nearly $44 billion estimated under prior law. This difference primarily stems from lower tax rates and the higher standard deduction, which will result in fewer itemizers. The equity loan limits themselves reduce tax expenditures only slightly from what they would have been. Lower tax rates alone reduce tax expenditures even more than these estimates indicate; however, the limits on consumer interest deductibility are likely to result in increased home equity loans to finance consumer goods and investment expenses on which interest is no longer directly deductible. This activity will partially offset the savings from the limits on mortgage interest deductions.

Contributions to Retirement and Pension Plans

TRA placed new limits on deductible contributions to individual retirement accounts (IRAs), to employer-sponsored qualified pension plans, and to other elective plans for income deferral.

Under prior law, an individual could deduct from gross income the amount contributed to an IRA up to the larger of $2,000 or 100 percent of employment income per year and then pay no taxes on income earned on the IRA until withdrawal of the proceeds. (The maximum for a household with a nonworking spouse was $2,250 for the household and $2,000 for either individual.) Under current law, the $2,000 (or $2,250) deduction is allowed only for taxpayers without employer-provided retirement plans, for joint filers with adjusted gross income under $40,000 (phased out between $40,000 and $50,000) and for single filers with AGI under $25,000 (phased out between $25,000 and $35,000). Taxpayers not eligible for the deduction may make a nondeductible contribution of up to $2,000 (or $2,250) a year. Taxes on all investment earnings from IRAs will still be deferred. Under current law, the projected tax expenditure in 1991 for IRA contributions and tax deferrals of investment income is $9 billion, compared with $19 billion under prior law.

The act also set further limits on the amount of wages that workers can exclude from current-year taxation by making deposits to salary reduction plans. (The most widely used of the salary reduction plans is governed by section 401(k) of the Internal Revenue Code.) Under these plans, employees may choose to receive lower current (taxable) income and to defer the remainder as a contribution to the plan. In general, the limit in 1987 will be $7,000; beginning in 1988, the $7,000 limit will be adjusted upward each year to reflect inflation.5/ Under prior law, the general limit was $30,000. Individuals who no longer qualify for IRAs may now choose to contribute to salary reduction plans, thereby offsetting some of the savings from the new limits on contributions.

Finally, the act applied limits to the amount of overall retirement savings that upper-income employees may accumulate through plans

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5. The limit on elective deferrals for tax-sheltered annuities sponsored by nonprofit and educational organizations will be $9,500, until the indexed $7,000 limit reaches $9,500.

sponsored by any one employer. The current limit on payments into defined contribution plans is the lesser of 25 percent of compensation or $30,000 per employee per year. The current limit on contributions to defined benefit plans is an amount that will result in annual benefits of the lesser of 100 percent of wages or about $94,000 per employee for any pension that begins at age 65. For employees eligible for payments from both types of plans sponsored by the same employer, a combined limit of the lesser of 140 percent of wages or about $117,500 in annual payments applies. These benefits are reduced on an actuarial basis for benefits payable before age 65.

As under prior law, an employer's contributions to a qualified pension plan are not taxed as compensation to individual employees at the time of deposit; rather, the participants pay tax on them later when they begin to receive payments from the plan. Also, as under prior law, interest and other investment income earned within qualified plans accumulates tax free until the participants in the plan receive the investment income, along with the original contributions.

The Omnibus Budget Reconciliation Act set a new limit on employers' deductible contributions to qualified defined benefit pension plans. The limit is now the amount by which 150 percent of the plan's termination liability exceeds the plan's assets. Previously, it was the amount by which the plan's accrued liability for projected benefits exceeded the plan's assets.

Prior law would have made the revenue loss from the net exclusion of pension contributions and earnings from taxes about $72 billion in 1991. The projection under current law is about $54 billion. The decline of $18 billion results both from new limits on contributions and from lower tax rates. Less than $1 billion of this decline stems from the provisions of the Reconciliation Act; the remainder is the result of changes enacted under TRA. (The net cost of pension contributions and savings is calculated by subtracting the amount of taxes paid on pension and other retirement income from the amount of current income excluded from taxation in the same year.)

Private-Purpose Tax-Exempt Financing

TRA further limited the use of tax-exempt bonds for private purposes. The bonds that state and local governments issue to finance public projects have traditionally been exempt from taxation and, for that reason, the interest rates on the bonds are below market. State and local governments have also issued bonds to finance quasi-public facilities, such as airports, and private-sector projects, such as housing. The below-market interest rates on these bonds reflect the federal subsidy of borrowing costs for private entities. "Private-purpose" tax-exempt bonds include: mortgage revenue bonds for rental housing and for single-family homes for low- and middle-income households; industrial development bonds (IDBs), used by private firms for a wide variety of purposes; student loan bonds, issued by state authorities to increase funds available for federally guaranteed student loans; and bonds for nonprofit institutions, such as hospitals and universities.

The act placed a single state-by-state limit on the volume of new issues of IDBs, student loan bonds, and housing and redevelopment bonds. The new state volume limits, which are more restrictive than under prior law, are now $50 per resident or $150 million per year. (For 1987, the limits were the greater of $75 per resident or $250 million per year.) Under prior law, the limit on IDBs and student loan bonds alone was $150 per resident or $200 million. Bonds for publicly-owned airports, ports, and solid waste disposal facilities, and for nonprofit, tax-exempt organizations (primarily hospitals and educational facilities) are exempt from the new volume limits. Tax exemption for mortgage revenue bonds and for small issue IDBs (under $10 million) used for manufacturing facilities will terminate at the end of 1988 and 1989, respectively.

These provisions represent a continuing attempt on the part of the Congress to control the use of tax-exempt financing for private purposes. Although more far-reaching, many of the TRA provisions are extensions of the restrictions passed in 1982 and 1984. The Reconciliation Act placed some additional limits on the use of tax-exempt bonds to acquire gas and electric generating, transmission, and distribution facilities. In total, the new provisions cut the cost of private-purpose tax-exempt financing by almost half from nearly $20 billion projected for 1991 under prior law to about $10 billion.

Other Base-Broadening Measures

Some of the less expensive, but nonetheless popular tax preferences that TRA either eliminated or modified are described below.

Deduction for Two-Earner Married Couples. Under prior law, married, two-earner taxpayers who filed joint returns could deduct 10 percent of the earned income of the lower-earning spouse, up to $3,000; this deduction would have cost more than $9 billion in 1991. TRA repeals the deduction. (Lower tax rates would have reduced its cost had the deduction been retained.)

Dividend Exclusions. The limited dividend exclusion for individuals was repealed effective December 31, 1986. Under prior law, the exclusion of $100 for individuals and $200 for married persons filing jointly would have cost slightly more than $0.5 billion in 1991.

Medical Deductions. The floor for medical deductions was increased from 5 percent to 7.5 percent of adjusted gross income. The currently estimated cost of medical deductions is nearly $3 billion in 1991, compared with more than $5 billion projected under prior law.

Political Contributions. The credit for political contributions ($50 for single returns and $100 for joint returns) was repealed. Under prior law, the credit would have cost less than $0.5 billion in 1991.

Scholarship and Fellowship Income. The exclusion for scholarship and fellowship income is now limited to the amount spent on tuition and course-related equipment. Previously, scholarship and fellowship funds could also be used for other expenses, such as room and board, without being subject to taxation. Tax expenditures in 1991, which under prior law would have been about $1 billion, are now expected to be $0.5 billion.

Special Tax Credits. Among the provisions affecting businesses, TRA permitted some special tax credits to expire, along with the regular investment tax credit (see above), including the credit for contributions to Employee Stock Ownership Plans and business energy tax credits. Rehabilitation tax credits were reduced from a 15 percent to 25 percent range to a two-tier, 10 percent to 20 percent range.

EFFECTS OF THE NEW RATE STRUCTURE

Even in cases where TRA did not change tax expenditure provisions, it reduced their costs. The reduction resulted from changes in the rate structure and from other changes in the tax base. For example, repealing the deductions for two-earner married couples and for consumer interest could result in fewer itemized returns, which in turn would reduce other tax expenditures. These types of changes in the tax base would cause other tax expenditures to decline even if both the provisions governing them and tax rates were unchanged. Similarly, lowering tax rates would cause tax expenditures to go down even if all other provisions remained the same.

For provisions that were unchanged, the changes in the rate structure were much more important in lowering tax expenditures than the other changes in the tax base. In fact, lower rates by themselves will always reduce tax expenditures, while base-broadening provisions can sometimes have countervailing effects. If any of the base-broadening provisions push taxpayers into higher marginal tax brackets without affecting the number of people who itemize their deductions, the costs of tax expenditures other than those directly changed will increase.

Among the provisions that tax reform left largely intact were the deductibility of state and local income taxes, the deductibility of property taxes on owner-occupied homes, the deductibility of charitable contributions, and the exclusion of employer contributions to medical insurance and other health care costs. The estimates in the following paragraphs illustrate how lower rates and higher standard deductions and personal exemptions affected these tax expenditures. To isolate the effects of the rate structure changes, the estimates compare the projected costs of the above items under prior law with the hypothetical costs that would result from applying the new rate structure to the other provisions of prior law, using the same economic assumptions (from CBO's January 1988 forecast). The comparisons are for fiscal year 1991, when virtually all of the provisions of TRA will be fully phased in (see Table 2 and Box 1).

State and Local Taxes

TRA repealed the deductibility of state and local sales taxes, but retained the deductibility of state and local income taxes, and real estate and personal property taxes. The deductions, in effect, make it possible for itemizers to pay state and local taxes at subsidized rates, which, in turn, might make them more willing to support higher levels of state and local services than they would otherwise. In other words, the deductions may indirectly increase state and local revenues at federal expense. Lower marginal tax rates and a higher standard deduction reduce both the number of itemizers and the value of the subsidy to them.

TABLE 2. PROJECTED REVENUE LOSSES FROM SELECTED TAX EXPENDITURES UNCHANGED BY TRA (In billions of dollars)

Tax Expenditure	Projected Revenue Losses for Fiscal Year 1991		
	Before TRA	After TRA	Difference
Deductibility of State and Local Income Taxes	28.1	18.4	9.7
Deductibility of Real Estate Taxes	12.4	8.9	3.5
Deductibility of Charitable Contributions	19.9	13.9	6.0
Exclusion of Employer Contributions to Medical Insurance and Health Care	42.0	37.7	4.3

SOURCES: Congressional Budget Office and Joint Committee on Taxation estimates.

NOTES: TRA = Tax Reform Act of 1986.

The year 1991 was chosen for comparison of projected tax expenditures because virtually all of the provisions of TRA will then be fully in effect.

The estimates under both prior law (before TRA) and current law (after TRA) are based on the same economic assumptions. These are from CBO's January 1988 forecast, which included projected changes in investment activity brought about by TRA.

If prior law had remained in effect, the estimated revenue loss from state and local income and personal property tax deductions in fiscal year 1991 would have been more than $28 billion, compared with the current law estimate of about $18 billion--a difference of $10

BOX 1
MEASURING THE EFFECTS OF CHANGES IN TAX RATES

It is possible to measure the effects of changes in tax rates on tax expenditures either (1) by comparing the revenue loss of an item under prior law with the hypothetical revenue loss that would result from applying the new rate structure to the provisions of prior law (prior law base), or (2) by comparing the revenue loss under current law with the revenue loss that would result from applying the rates in prior law to the provisions in current law (current law base). The answers will differ slightly, depending on whether one uses the prior or current law base to measure change. In this report, the base is prior law. The table below shows how the results would vary if the base were current law. It also points out that, for provisions not directly changed by tax reform legislation, the reduction in revenue losses resulted largely from changes in tax rates, rather than from changes in other provisions that broadened the tax base.

Revenue Loss Differences for Selected Tax Expenditures Unchanged by TRA (Fiscal year 1991, in billions of dollars)

Provision	Current Law Rates and Base minus Prior Law Rates and Base	Current Law Rates and Prior Law Base minus Prior Law Rates and Base	Current Law Rates and Base minus Prior Law Rates and Current Law Base
Deductibility of:			
State and Local Income Taxes	-9.7	-8.6	-8.7
State and Local Real Estate Taxes	-3.5	-3.4	-3.9
Charitable Contributions	-6.0	-5.6	-6.2
Exclusion from Income of:			
Employer Contributions to Medical Insurance and Health Care	-4.3	-5.8	-7.0

SOURCE: Congressional Budget Office.

billion. If the current rate structure had applied to the other provisions in prior law, the revenue loss would have been $19.5 billion. The change in the rate structure alone, then, reduced tax expenditures from state and local income tax deductions by almost $9 billion. Other changes in the tax base accounted for the remaining $1 billion in reduced tax expenditures.

In 1991, revenue losses from state and local real estate tax deductions will amount to nearly $9 billion under current law, compared with about $12 billion if prior law had remained in effect. If current law rates had applied to prior law, these tax expenditures would have cost $9 billion. The change in the rate structure, then, accounted almost entirely for this $3 billion reduction in tax expenditures from real estate deductions.

Charitable Contributions

Under prior law, nonitemizers were permitted to deduct charitable contributions through December 31, 1986. In this respect, current law, which prohibits nonitemizers from deducting charitable contributions, represents no change from prior law. The projected cost of itemized deductions for charitable contributions in 1991 is close to $14 billion, compared with nearly $20 billion under prior law. The change in the rate structure accounted for accounted for most of this nearly $6 billion reduction in tax expenditures; other changes in the tax base lowered tax expenditures by less than $0.5 billion.

Exclusion of Employer Contributions to Life Insurance and Health Care

As under prior law, an employer's contributions to an employee's health care costs--whether for medical insurance, physical examinations, prescription drugs, or any other medical expense--are excluded from individual taxable income, although the contributions are a deductible expense for the employer. Under current law, the exclusion of employer contributions to life insurance and health care will cost nearly $38 billion in 1991, compared with $42 billion if prior law were still in effect--a decrease of about $4 billion. If current law rates had

applied to prior law, the cost would have been about $36 billion, indicating that rate structure changes alone would have reduced these tax expenditures by about $6 billion, while other tax base changes had a countervailing effect, so that the actual change was less.

NEW TAX CREDITS

The main exception to base-broadening was the enactment of a new tax credit for low-income housing to replace provisions that were repealed. Under prior law, the incentives for investment in low-income housing included special accelerated depreciation, five-year amortization of rehabilitation expenses, expensing of construction period interest and taxes, and tax-exempt bond financing for multi-family residential rental property. Under TRA, new construction and rehabilitation expenditures for low-income housing placed in service in 1987 are eligible for a maximum 9 percent credit, paid annually for 10 years.6/ The acquisition cost of existing property and the cost of newly constructed projects receiving other federal subsidies, notably tax-exempt bonds, are eligible for a 4 percent credit, also paid for 10 years. For buildings placed in service after 1987, these percentages will be adjusted to yield over a 10-year period amounts of credit with a present value of 70 percent or 30 percent of development or acquisition costs. (The larger credit is for new construction or substantial rehabilitation with no other federal subsidies.) A residential rental project qualifies for the credit only if: (1) 20 percent or more of the rental units in a project are occupied by individuals with incomes of 50 percent or less of area median income, as adjusted for family size, or (2) 40 percent or more of the units are occupied by individuals with incomes of 60 percent or less of area median income, as adjusted for family size.

Each state is limited to an annual credit authority equal to $1.25 for each state resident. If, however, a project is financed with tax-exempt bonds, it is exempt from these limits and subject to the volume

6. Rent subsidies under section 8 of the Housing and Community Development Act of 1974 (Public Law 93-383), as amended, and federal housing insurance under the National Housing Act of 1934 (Public Law 73-479), as amended, are not considered to be "other federal subsidies" for the purposes of this provision.

limits placed on tax-exempt bonds for private purposes. A portion of each state's set-aside must be allocated for the exclusive use of non-profit organizations; this portion must be equal to at least $0.125 for each resident. State agencies will administer the credit programs under the general supervision of the Treasury Department.

The low-income housing tax credit is expected to reduce revenues by between $0.5 billion and $1 billion in fiscal year 1991. Under prior law, the cost of tax preferences for low-income housing--accelerated cost recovery, five-year amortization of rehabilitation expenses, and special deductions for construction period interest and taxes--would have been roughly similar. Because it largely substitutes for these previous preferences, the new credit represents no significant departure from the principles of tax reform, nor does it in any way diminish the overall effect that base-broadening and lower rates had on reducing tax expenditures.

APPENDIXES

APPENDIX A

TAX EXPENDITURE ESTIMATES FOR FISCAL YEARS 1989-1993

This appendix provides estimates for tax expenditure revenue losses by budget function and subfunction for fiscal years 1989 to 1993 (see Table A-1). These tax expenditure estimates are identical to those published by the Joint Committee on Taxation (JCT) in March 1988. The estimates reflect the provisions not only of the Tax Reform Act of 1986, but also of the Omnibus Budget Reconciliation Act, passed in December 1987.

From a revenue standpoint, the most important tax expenditure provisions in the Reconciliation Act and the estimated gains from them between fiscal years 1989 and 1993 are as follows:

- Repeal of vacation pay reserves, which will raise an estimated $7.2 billion (most of these revenues will come from corporate taxes);

- Further restriction on the use of the completed contract method of accounting, which will increase revenues by $2.6 billion (primarily from corporate taxes);

- Repeal of the installment method of accounting for dealers, which will raise $8.7 billion (primarily from corporate taxes); and

- Modification of the pension funding rules, which will raise $3.6 billion (primarily from individual taxes).

Apart from the above provisions, the effect of the Reconciliation Act on most tax expenditures was small.

TABLE A-1. TAX EXPENDITURE ESTIMATES BY BUDGET FUNCTION AND SUBFUNCTION, FISCAL YEARS 1989-1993 (In billions of dollars)

Budget Function and Subfunction	Corporations					Individuals				
	1989	1990	1991	1992	1993	1989	1990	1991	1992	1993
050 NATIONAL DEFENSE										
051 Department of Defense - Military										
Exclusion of benefits and allowances to Armed Forces personnel	---	---	---	---	---	1.7	1.8	1.8	1.9	2.0
Exclusion of military disability pensions	---	---	---	---	---	0.1	0.1	0.1	0.1	0.1
150 INTERNATIONAL AFFAIRS										
155 International Finance Programs										
Exclusion of income earned abroad by United States citizens	---	---	---	---	---	1.3	1.4	1.5	1.6	1.7
Exclusion of certain allowances for federal employees abroad	---	---	---	---	---	0.2	0.2	0.2	0.2	0.2
Exclusion of income of foreign sales corporations	0.6	0.7	0.7	0.8	1.0	---	---	---	---	---
Deferral of income of controlled foreign corporations	0.1	0.1	0.1	0.1	0.1	---	---	---	---	---
Inventory property sales source rule exception	2.3	2.6	2.9	3.3	3.7	---	---	---	---	---
Interest allocation rules exception for certain nonfinancial institutions	0.1	0.1	0.1	0.1	0.1	---	---	---	---	---

(continued)

TABLE A-1. (Continued)

Budget Function and Subfunction	Corporations					Individuals				
	1989	1990	1991	1992	1993	1989	1990	1991	1992	1993
250 GENERAL SCIENCE, SPACE, AND TECHNOLOGY										
251 General Science and Basic Research										
Expensing of research and development expenditures	1.1	1.2	1.4	1.5	1.7	a/	a/	a/	a/	0.1
Credit for increasing research activities	0.6	0.1	a/	a/	a/	a/	a/	a/	a/	a/
270 ENERGY										
271 Energy Supply										
Expensing of exploration and development costs										
Oil and gas	-0.7	-0.5	-0.3	a/	0.3	0.4	0.5	0.5	0.6	0.6
Other fuels	a/	a/	a/	a/	a/	a/	a/	a/	a/	a/
Excess of percentage over cost depletion										
Oil and gas	0.1	0.1	0.1	0.1	0.1	0.3	0.3	0.3	0.4	0.4
Other fuels	0.2	0.2	0.2	0.3	0.3	a/	a/	a/	a/	a/
Exception from passive loss limitation for working interests in oil and gas properties	---	---	---	---	---	0.3	0.3	0.4	0.4	0.5

(continued)

TABLE A-1. (Continued)

Budget Function and Subfunction	Corporations					Individuals				
	1989	1990	1991	1992	1993	1989	1990	1991	1992	1993
Energy Supply (continued)										
Alternative fuel production credit	a/	a/	a/	a/	a/	---	---	---	---	---
Alcohol fuel credit b/	a/	a/	a/	a/	a/	a/	a/	a/	a/	a/
Exclusion of interest on state and local government industrial development bonds for energy production facilities	c/	c/	c/	c/	c/	0.2	0.2	0.2	0.2	0.2
Expensing of tertiary injectants (for oil recovery)	a/	a/	a/	a/	a/	a/	a/	a/	a/	a/
300 NATURAL RESOURCES AND ENVIRONMENT										
302 Conservation and Land Management										
Expensing multiperiod timber growing costs	0.3	0.3	0.3	0.4	0.4	a/	a/	a/	a/	a/
Investment credit and seven-year amortization for reforestation expenditures	a/	a/	a/	a/	a/	a/	a/	a/	a/	a/

(continued)

TABLE A-1. (Continued)

Budget Function and Subfunction	Corporations					Individuals				
	1989	1990	1991	1992	1993	1989	1990	1991	1992	1993
303 Recreational Resources										
Investment tax credit and passive loss exception for rehabilitation of historic structures	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
304 Pollution Control and Abatement										
Exclusion of interest on state and local government sewage, water, and hazardous waste facilities bonds	-0.3	-0.3	-0.4	-0.4	-0.4	1.4	1.6	1.6	1.7	1.8
306 Other Natural Resources										
Expensing of exploration and development costs, nonfuel minerals	a/	a/	0.1	0.1	0.1	a/	a/	a/	a/	a/
Excess of percentage over cost depletion, nonfuel minerals	0.2	0.2	0.3	0.3	0.3	a/	a/	a/	a/	a/
Special rules for mining reclamation reserves	a/	a/	a/	a/	a/	a/	a/	a/	a/	a/
350 AGRICULTURE										
351 Farm Income Stabilization										
Expensing of certain capital outlays	0.1	0.1	0.1	0.1	0.1	a/	a/	a/	0.1	0.1

(continued)

TABLE A-1. (Continued)

Budget Function and Subfunction	Corporations					Individuals				
	1989	1990	1991	1992	1993	1989	1990	1991	1992	1993
Farm Income Stabilization (continued)										
Deductibility of patronage dividends and certain other items of cooperatives	0.3	0.3	0.3	0.3	0.3	-0.1	-0.1	-0.1	-0.1	-0.1
Exclusion of certain cost-sharing payments	---	---	---	---	---	a/	a/	a/	a/	a/
Exclusion of cancellation of indebtedness income of farmers	---	---	---	---	---	a/	a/	a/	a/	a/
Expensing certain multiperiod production costs	a/	a/	a/	a/	a/	a/	a/	a/	a/	a/
370 COMMERCE AND HOUSING CREDIT										
371 Housing										
Deductibility of mortgage interest on owner-occupied principal and second homes	---	---	---	---	---	30.8	35.0	35.8	38.1	40.6
Deductibility of property tax on owner-occupied homes	---	---	---	---	---	8.0	8.4	8.9	9.4	9.9
Exclusion of interest on state and local government housing bonds for owner-occupied housing	0.3	0.3	0.3	0.3	0.3	1.4	1.3	1.3	1.2	1.1
Exclusion of interest on state and local government housing bonds for rental housing	0.2	0.2	0.2	0.2	0.2	0.7	0.7	0.7	0.7	0.7
Deferral of capital gains on home sales	---	---	---	---	---	9.3	10.6	11.6	12.6	13.7

(continued)

TABLE A-1. (Continued)

Budget Function and Subfunction	Corporations					Individuals				
	1989	1990	1991	1992	1993	1989	1990	1991	1992	1993
Housing (continued)										
Exclusion of capital gains on home sales for persons aged 55 and over	---	---	---	---	---	3.3	3.5	3.9	4.2	4.9
Depreciation of rental housing in excess of alternative depreciation system	0.2	0.3	0.3	0.3	0.4	0.8	0.9	0.9	1.0	1.0
Credit and passive loss exception for low-income housing	0.1	0.1	0.1	0.1	0.1	0.3	0.5	0.6	0.6	0.6
Financial Institutions										
Excess bad debt reserves of financial institutions	0.2	0.2	0.2	0.2	0.2	---	---	---	---	---
Merger rules for thrift institutions	0.2	0.2	0.1	0.1	a/	---	---	---	---	---
Exemption of credit union income	0.4	0.4	0.5	0.5	0.5	---	---	---	---	---
Insurance Companies										
Exclusion of interest on life insurance and annuity savings	0.3	0.4	0.4	0.4	0.5	5.2	5.8	6.3	7.0	7.6
Small life insurance company taxable income adjustment	0.1	0.1	0.1	0.1	0.1	---	---	---	---	---
Treatment of life insurance company reserves	0.5	0.6	0.7	0.7	0.7	---	---	---	---	---
Deduction of unpaid losses for property treatment of casualty insurance companies	2.4	2.0	2.0	1.6	1.4	---	---	---	---	---

(continued)

TABLE A-1. (Continued)

Budget Function and Subfunction		Corporations					Individuals				
		1989	1990	1991	1992	1993	1989	1990	1991	1992	1993
	Insurance Companies (continued)										
	Special alternative tax on small property and casualty insurance companies	a/	a/	a/	a/	a/	---	---	---	---	---
	Tax exemption for certain insurance companies	a/	a/	a/	a/	a/	---	---	---	---	---
	Special deduction for Blue Cross and Blue Shield companies	a/	0.1	0.1	a/	a/	---	---	---	---	---
376	Other Business and Commerce										
	Exclusion of interest on state and local small issue bonds	-0.2	-0.1	-0.1	-0.1	-0.1	2.3	2.3	2.2	2.2	2.2
	Deduction of personal interest	---	---	---	---	---	5.7	3.2	0.9	---	---
	Depreciation on buildings other than rental housing in excess of alternative depreciation system	4.6	4.8	4.9	5.0	5.1	1.7	1.8	2.0	2.1	2.1
	Depreciation on equipment in excess of alternative depreciation system	10.3	11.2	12.5	14.2	16.0	3.4	3.8	4.0	4.3	4.8
	Investment credit other than ESOPs, rehabilitation of structures, reforestation, and energy property	3.2	2.7	1.5	0.8	0.2	0.6	0.2	0.1	0.1	a/
	Amortization of business start-up costs	a/	a/	a/	a/	a/	0.2	0.1	0.1	0.1	0.1

(continued)

TABLE A-1. (Continued)

Budget Function and Subfunction	Corporations					Individuals				
	1989	1990	1991	1992	1993	1989	1990	1991	1992	1993
Other Business and Commerce (continued)										
Exclusion of capital gains at death	---	---	---	---	---	4.5	4.8	5.1	5.4	5.8
Reduced rates on first $75,000 of corporate income	5.0	5.2	5.5	5.7	6.0	---	---	---	---	---
Expensing up to $10,000 depreciable business property	0.7	0.6	0.2	0.2	0.1	0.3	0.2	0.1	0.1	0.1
Like-kind exchanges	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2
Exceptions from net operating loss limits for corporations in bankruptcy	0.2	0.2	0.2	0.2	0.2	---	---	---	---	---
Permanent exemption from imputed interest rules	a/	a/	a/	a/	a/	0.1	0.1	0.2	0.2	0.2
Expensing magazine circulation expenditures	a/	a/	a/	a/	a/	a/	a/	a/	a/	a/
Special rules for magazine, paperback, and record returns	a/	a/	a/	a/	a/	a/	a/	a/	a/	a/
Deferral of gain on installment sales	0.1	0.1	0.1	0.1	0.1	a/	a/	a/	a/	a/
Completed contract rules	-2.8	-1.7	-0.4	0.1	0.2	-0.1	-0.1	c/	c/	a/
Cash accounting, other than agriculture	a/	a/	a/	a/	a/	a/	a/	a/	a/	a/
Exemption from passive loss rules for $25,000 of rental losses	---	---	---	---	---	2.7	3.5	3.8	3.8	3.7

(continued)

TABLE A-1. (Continued)

Budget Function and Subfunction	Corporations					Individuals				
	1989	1990	1991	1992	1993	1989	1990	1991	1992	1993
400 TRANSPORTATION										
Exclusion of interest on state and local government bonds for mass transit vehicles and facilities	c/	c/	c/	c/	c/	a/	a/	a/	a/	a/
Deferral of tax on capital construction funds of shipping companies	0.1	0.1	0.1	0.1	0.1	---	---	---	---	---
450 COMMUNITY AND REGIONAL DEVELOPMENT										
451 Community Development										
Investment credit and passive loss exception for rehabilitation of nonhistoric structures	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Exclusion of interest on state and local government bonds for private airports and docks	-0.1	-0.1	-0.1	-0.1	-0.2	0.6	0.6	0.7	0.8	0.9

(continued)

TABLE A-1. (Continued)

Budget Function and Subfunction	Corporations					Individuals				
	1989	1990	1991	1992	1993	1989	1990	1991	1992	1993
500 EDUCATION, TRAINING, EMPLOYMENT, AND SOCIAL SERVICES										
Education and Training										
Exclusion of scholarship and fellowship income	---	---	---	---	---	0.4	0.4	0.5	0.5	0.6
Exclusion of interest on state and local government student loan bonds	0.1	a/	a/	a/	a/	0.2	0.3	0.3	0.3	0.3
Exclusion of interest on state and local government bonds for private educational facilities	a/	a/	a/	a/	a/	0.4	0.4	0.4	0.5	0.5
Parental personal exemption for students aged 19 or over	---	---	---	---	---	0.3	0.3	0.3	0.4	0.4
Deductibility of charitable contributions (education)	0.4	0.4	0.5	0.6	0.6	1.2	1.3	1.3	1.4	1.4
504 Employment										
Targeted jobs credit	0.2	0.1	0.1	a/	a/	a/	a/	a/	---	---
Employee Stock Ownership Plans d/	0.3	0.3	0.3	0.3	0.3	---	---	--	---	---
Exclusion of cafeteria plans	---	---	---	---	---	1.1	1.8	2.7	3.5	4.2

(continued)

TABLE A-1. (Continued)

Budget Function and Subfunction	Corporations					Individuals				
	1989	1990	1991	1992	1993	1989	1990	1991	1992	1993
Employment (continued)										
Exclusion of rental allowances of minister's home	---	---	---	---	---	0.2	0.2	0.2	0.2	0.2
Exclusion of miscellaneous fringe benefits	---	---	---	---	---	3.7	4.1	4.4	4.7	5.1
Exclusion of income earned by benefit organizations:										
Supplemental unemployment benefit trusts	---	---	---	---	---	a/	a/	a/	a/	a/
Voluntary employee beneficiary associations	---	---	---	---	---	0.4	0.5	0.5	0.5	0.5
Exclusion of employee awards	---	---	---	---	---	0.1	0.1	0.1	0.1	0.1
Social Services										
Deductibility of charitable contributions, other than for education and health	0.4	0.5	0.5	0.6	0.6	9.5	9.8	10.1	10.4	10.7
Credit for child and dependent care expenses	---	---	---	---	---	4.0	4.1	4.3	4.5	4.6
Exclusion for employer-provided child care	---	---	---	---	---	0.2	0.3	0.5	0.7	0.9
Exclusion for certain foster care payments	---	---	---	---	---	a/	a/	a/	a/	a/
Expensing costs of removing architectural barriers	a/	a/	a/	a/	a/	a/	a/	a/	a/	a/

(continued)

TABLE A-1. (Continued)

Budget Function and Subfunction	Corporations					Individuals				
	1989	1990	1991	1992	1993	1989	1990	1991	1992	1993
550 HEALTH										
Exclusion of contributions by employers and self-employed for medical insurance premiums and medical care	---	---	---	---	---	27.6	32.3	37.7	41.0	45.8
Deductibility of medical expenses	---	---	---	---	---	2.5	2.7	2.9	3.2	3.4
Exclusion of interest on state and local government bonds for hospital facilities	a/	a/	0.1	0.1	0.1	2.1	2.3	2.5	2.8	3.0
Deductibility of charitable contributions for health	0.2	0.2	0.2	0.2	0.2	1.2	1.2	1.3	1.3	1.4
Tax credit for orphan drug research	a/	a/	a/	---	---	---	---	---	---	---
MEDICARE										
Exclusion of untaxed Medicare benefits										
Hospital Insurance	---	---	---	---	---	4.3	4.7	5.2	5.7	6.3
Supplementary Medical Insurance	---	---	---	---	---	2.2	2.5	2.8	3.1	3.5

(continued)

TABLE A-1. (Continued)

Budget Function and Subfunction	Corporations					Individuals				
	1989	1990	1991	1992	1993	1989	1990	1991	1992	1993
600 INCOME SECURITY										
Exclusion of untaxed railroad retirement system benefits	---	---	---	---	---	0.4	0.4	0.4	0.4	0.4
Exclusion of workmen's compensation benefits	---	---	---	---	---	2.9	3.2	3.6	4.0	4.4
Exclusion of special benefits for disabled coal miners	---	---	---	---	---	0.2	0.2	0.2	0.2	0.2
Exclusion of public assistance benefits	---	---	---	---	---	0.3	0.3	0.3	0.4	0.4
Net exclusion of pension contributions and earnings	---	---	---	---	---	45.6	48.2	51.1	54.5	57.2
Keogh plans	---	---	---	---	---	2.2	2.3	2.5	2.7	3.0
Individual retirement plans	---	---	---	---	---	8.0	8.5	9.0	9.7	10.6
Exclusion of other employee benefits										
Premiums on group term life insurance	---	---	---	---	---	1.7	1.8	1.9	2.0	2.1
Premiums on accident and disability insurance	---	---	---	---	---	0.1	0.1	0.1	0.1	0.1
Exclusion for employer-provided death benefits	---	---	---	---	---	a/	a/	a/	a/	a/
Additional standard deduction for the blind and elderly	---	---	---	---	---	1.1	1.2	1.3	1.4	1.5
Tax credit for the elderly and disabled	---	---	---	---	---	0.2	0.2	0.2	0.2	0.2
Deductibility of casualty and theft losses	---	---	---	---	---	0.2	0.2	0.2	0.1	0.1
Earned income credit e/	---	---	---	---	---	1.2	1.4	1.5	1.7	1.8

(continued)

TABLE A-1. (Continued)

Budget Function and Subfunction	Corporations					Individuals				
	1989	1990	1991	1992	1993	1989	1990	1991	1992	1993
650 SOCIAL SECURITY										
Exclusion of untaxed Social Security benefits:										
Disability insurance benefits	---	---	---	---	---	1.4	1.4	1.5	1.6	1.7
OASI benefits for retired workers	---	---	---	---	---	12.6	13.4	14.3	15.1	16.1
Benefits for dependents and survivors	---	---	---	---	---	4.0	4.3	4.5	4.8	5.1
700 VETERANS' BENEFITS AND SERVICES										
Exclusion of veterans' disability compensation	---	---	---	---	---	1.3	1.3	1.4	1.4	1.4
Exclusion of veterans' pensions	---	---	---	---	---	0.1	0.1	0.1	0.1	0.1
Exclusion of GI bill benefits	---	---	---	---	---	0.1	0.1	0.1	0.1	0.1
Exclusion of interest on state and local government veterans' housing bonds	0.1	0.1	a/	a/	a/	0.2	0.2	0.2	0.2	0.2
850 GENERAL PURPOSE FISCAL ASSISTANCE										
Exclusion of interest on general purpose state and local government debt	1.5	1.4	1.3	1.3	1.3	7.8	8.7	9.6	10.6	11.3
Deductibility of nonbusiness state and local government income and personal property taxes	---	---	---	---	---	16.5	17.4	18.4	19.4	20.4

(continued)

TABLE A-1. (Continued)

Budget Function and Subfunction	Corporations					Individuals				
	1989	1990	1991	1992	1993	1989	1990	1991	1992	1993
GENERAL PURPOSE FISCAL ASSISTANCE (continued)										
Exclusion and tax credit for corporations with possessions source income	2.6	2.9	3.2	3.4	3.6	---	---	---	---	---
900 INTEREST										
Deferral of interest on savings bonds	---	---	---	---	---	0.9	0.9	0.9	0.9	1.0

SOURCE: Congressional Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1989-1993* (March 8, 1988), pp. 10-16.

NOTES: Numbers in far left column refer to the budget function or subfunction category.
Dashes indicate zero or negligible tax expenditures.
ESOP = Employee Stock Ownership Plan; OASI = Old-Age and Survivors Insurance.

a. Positive tax expenditure of less than $50 million.
b. In addition, the exemption from the excise tax for alcohol fuels results in a reduction in excise tax receipts, net of the income tax effect, of $0.3 billion per year from 1989 through 1993.
c. Negative tax expenditure of less than $50 million.
d. Includes effects of tax credit, dividend deduction, nonrecognition of gain on stock sales, and exclusion of interest on ESOP loans.
e. The figures in the table show the effect of the earned income credit on receipts. The increase in outlays is $5.0 billion in 1989, $5.4 billion in 1990, $5.9 billion in 1991, $6.5 billion in 1992, and $7.1 billion in 1993.

APPENDIX B

DIFFERENCES BETWEEN THE TAX EXPENDITURE LISTS OF THE ADMINISTRATION AND THE CONGRESSIONAL AGENCIES

The following tax expenditure items appear on the list of the Joint Committee on Taxation, but are not included in Special Analysis G of the President's Budget. The differences between the lists result largely from JCT's having added provisions recommended for repeal in the tax reform proposals put forth by the Treasury Department and the President in 1984 and 1985. Also, the lists cover different years, and JCT's list includes repealed and expired provisions that, because of transition rules and the timing of payments, continue to result in revenue losses.1/

International Affairs

Exclusion of certain allowances for federal employees abroad

Energy

Exception from passive loss rules for working interests in oil and gas properties

Expensing of tertiary injectants (used for enhanced oil recovery)

Agriculture

Deductibility of patronage dividends and certain other items of cooperatives

Exclusion of cost-sharing payments

Cash accounting

Financial Institutions

Merger rules for thrift institutions

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1. Sources for this list are Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1989-1993* (March 8, 1988), pp. 5-6; Office of Management and Budget, *Special Analyses, Budget of the United States Government, Fiscal Year 1989*, pp. G-41 to G-45.

Tax exemption for certain insurance companies
Special deduction for Blue Cross-Blue Shield companies
Deduction of unpaid losses of property and casualty companies
Special rules for life insurance company reserves
Exclusion of income from structured settlement amounts

Business and Commerce

Expensing of up to $10,000 depreciable business property
Permanent exemption from imputed interest rules
Special rules for magazine, paperback, and record returns
Expensing of magazine circulation expenditures
Completed contract rules
Cash accounting, other than agriculture
Exclusion of capital gains at death

Employment

Exclusion of benefits from cafeteria plans
Exclusion of miscellaneous fringe benefits
Exclusion of employee awards
Exclusion of income earned by voluntary employee beneficiary associations (VEBAs)

Social Services

Expensing of costs for removing architectural barriers
Exclusion of employer-provided child care
Exclusion of certain foster care payments

Medicare

Exclusion of untaxed Medicare benefits

Income Security

Exclusion of employer-provided death benefits

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